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PARTNERSHIPS OR JOINT VENTURES AS VEHICLES TO ACHIEVE CHARITABLE OBJECTIVES

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Tax-exempt organizations are facing new dilemmas as traditional funding sources decline and demands for their services escalate. At the same time, the law is rapidly changing, causing an increase in pressures on those who manage, advise, and administer these organizations. There are several factors that have combined to change the character of exempt organizations. These factors include the unstructured growth of the exemption provisions, the growth of the exempt sector, the commercialization of the exempt sector, and the growth and sophistication of the tax laws. I will briefly focus on these factors and explain how they have combined, in the face of decreased funding and increased demands for services, to change the character of many exempt organizations.

The exemption provisions of Subchapter F of the Internal Revenue Code were enacted over a period of ninety years by a variety of legislators for a variety of reasons. They were not the result of any planned legislative scheme, and have never been set forth as part of any unified concept of exemption.

The first exemption provisions appeared in the Tariff Act of 1894, when our early legislators implemented the country's first income tax by imposing a flat two percent tax on individuals and corporate net income. This scheme raised the issue of whether all corporations would be subject to the tax. Ultimately, it was decided that an exemption would be provided for charitable, religious, and educational organizations, fraternal beneficiary societies, certain mutual savings banks and certain mutual insurance companies. While this law was later declared unconstitutional,

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advocates of an income tax pressed on and were successful in imposing a one percent tax on net corporate income in the Tariff Act of 1909. Here, exemption provisions from the 1894 Act were re-enacted, and an exemption for labor organizations was added. To date, the exemption provision for labor unions remains in the Internal Revenue Code, and provides for the exemption of some of the most powerful organizations in the country.

Many of the other exemption provisions similarly had their origins, without explanation, in our early tax statutes. Recently, for example, the General Accounting Office ("GAO") was examining the IRS' administration of exempt rural electric cooperatives-organizations that are described in section 501(c)(12) of the Code. The GAO noted that the environment and operations of rural electric cooperatives have changed dramatically since 1916 when the exemption provision was initially enacted. Indeed, the GAO noted that many of today's exempt entities closely resemble their for-profit counterparts. The GAO concluded that the broad nature of the statute provides exemption for all cooperatives regardless of differences in operations and activities, financial conditions, size, or mix of consumers served. In a report to Congress, the GAO said legislation is needed to improve the administration of this exemption provision.

A second factor that has impacted on the changing character of exempt organizations is the growth of the exempt sector. The exempt sector is big. IRS' Exempt Organizations Business Master file lists 841,972 organizations as exempt. That, of course, does not include the church or church-related organizations that are not required to file returns. This number includes approximately 349,000 section 501(c)(3) organizations. During the past decade there has been an increase of 150,000 exempt entities, including 107,000 section 501(c)(3) organizations. Thus, approximately seventy-one percent of the growth in the exempt sector over the past decade has been in the section 501(c)(3) area.

IRS statistics show non-profit charitable organizations reporting total revenue of $196.3 billion and total expenditures of $181.3 billion for the 1982 reporting year. A recent study by the Urban Institute, also focusing on the 1982 reporting year, found that there were one and one-half times as many public benefit service organizations as there were units of government in the country; that the sector employed 6.5 million people (five times as many people as the automobile industry); and that it accounted for about five percent of the gross domestic product.

The third factor that I would like to discuss with respect to the changing character of exempt organizations is the increasingly commercial nature of these organizations. Escalating expenses, declining revenue, and a rising demand for highly technical services have forced many organizations into the commercial arena. This has been a subject of intense public discussion and intense coverage in the media. Last November, the *Washington Post* ran a series of articles, each on the front page,

entitled "The Nonprofits Business—Battling The Bottom Line." One of the articles quoted the Director of the Houston Art Museum saying that "[t]he only thing that separates the aggressive, entrepreneurial non-profit institution [from others] is that the ones that aren't so aggressive haven't learned how to be yet." Recently, *The Wall Street Journal* published an article entitled "YMCA's New Elite Clubs Charge That It Abused Its Tax Exempt Status." The article complained about unfair competition by YMCA with taxable health and racket clubs.

Administration agencies have also analyzed the increasingly commercial character of exempt organizations. The Small Business Administration has twice issued reports entitled "Unfair Competition by Nonprofit Organizations with Small Business." The General Accounting Office, studying the Internal Revenue Service's administration of the unrelated business income tax, noted that the filing of the unrelated business income tax returns during the past decade increased from 11,000 returns to 23,000 returns. The GAO attributed the growth to increased business activities by exempt organizations in the face of reduced government support.

Perhaps the most impressive study on the changing character of exempt organizations was conducted by the Urban Institute Nonprofit Sector Project (the "Project"). That study was a three year inquiry into the scope, structure, and roles of the non-profit sector that was supported by over forty grant makers. The Project found that for the 1984 fiscal year, federal support for the non-profit sector was estimated to be $4.5 billion below what it was in the 1980 fiscal year. The Project also found that non-profits, as a group, were able to offset the government cutbacks between 1981 and 1982, but only by turning to commercial sources of income. In an article in the *Foundation News*, talking about the results of this study, one of the Urban Institute directors stated:

> As government support declines, private charity fails to fill the gap, and organizations turn increasingly towards commercial sources of income instead, the sectors willingness and ability to serve those in great need may decline, underlying the sectors raison d'etre in the process.

The final factor that has had an impact on the changing character of exempt organizations is the growth and sophistication of the tax laws. There has been a flood of major tax legislation during the last decade. Since the enactment of the Employee Retirement Income Security Act of 1974, the Internal Revenue Code has been amended by 122 public laws. Eight of these amendments have been major tax bills that have added 1,327 pages of statutes or statutory amendments to the Internal Revenue Code. Note that these are 1,327 pages of statutes or statutory amendments, not 1,327 statutes. The last three major tax bills alone have added 988 pages of statutes or statutory amendments to the Code within the

past five years. Judging by the size of last year's House bill, H.R. 3838, there is very good chance that subsequent tax reform legislation will surpass the 537 pages of statutes or statutory amendments added to the Code by the 1984 Act.

While there have been massive amendments to the Internal Revenue Code, the exemption provisions of Subchapter F, for the most part, have escaped major change. Changes to other portions of the Code, however, have had a significant impact on the financial transactions that exempt organizations enter into.

Subsequent to the Economic Recovery Tax Act of 1981, it became clear that the safe harbor leasing provisions, the accelerated cost recovery system ("ACRS") provisions, and the rehabilitation investment tax credit could be utilized by exempt organizations. Shortly thereafter, the Claims Court held that the investment tax credit could be utilized in transactions with exempt organizations. Exempt organizations began entering sophisticated, complex transactions involving previously inapplicable provisions of the Code. Indeed, privatization, a method of financing a tax-exempt entity's capital project by taking advantage of tax incentives available only to the private sector, was exploited by many exempt organizations. In one instance, an entire college campus was sold to and leased back from its alumni. Section 168(j) was enacted in the Tax Reform Act of 1984 to reduce the tax benefits that would otherwise be available for tangible property used by tax-exempt entities by extending the period over which the property could be written off. These provisions have become known as the tax-exempt entities leasing rules.

I would now like to analyze how these four factors impacted on particular segments of the exempt sector—the non-profit community hospitals. The basis for the exemption of the non-profit community hospital is found in section 401(c)(3), the earliest of our exemption statutes. Our Statistics of Income Report reflects that non-profit community hospitals are one of the largest groups of tax-exempt organizations on the basis of numbers of returns filed, total assets, and total revenue.

The character of nonprofit hospitals has also changed dramatically in the wake of deregulation and increased competition. This change was sparked by the federal government's movement away from a cost reimbursement system to a prospective payment system based on pre-set prices. As this financial structure was changing, hospitals were faced with competition from chains of efficiently run, for-profit corporations. Faced with competition for patients and a new price consciousness, hospitals have become aggressive businesses. Today, most nonprofit community hospitals have abandoned the single corporate structure, undergone corporate reorganization, and have expanded into systems of related health care organizations to provide a wide range of services, products, and joint ventures. The most typical reorganized hospital system would involve a

section 501(c)(3) entity that provides health care, a related fund-raising organization, a tax-exempt real estate holding company, a human services corporation, and a taxable subsidiary corporation, all controlled by a tax-exempt parent. Corporate diagrams of some of the large hospital systems in this country include forty to fifty entities.

To survive in today's competitive atmosphere, many hospital systems engage in sophisticated joint venture and partnership transactions that involve issues beyond those traditionally considered under section 501(c)(3). These transactions are frequently structured to acquire high technology equipment or to build medical facilities and often have doctors affiliated with the hospital as partners or joint venturers.

The changing character of exempt organizations provides a number of challenges for the Internal Revenue Service. The dramatic and swift change in the nonprofit hospital community from the single corporate entity to the multi-tiered charitable enterprise of organizations, including taxable subsidiary corporations, raises the issue of whether the Service is facing a hybrid group of entities somewhere between the exempt organization and its commercial counterpart.

The changing character of an exempt organization also poses administrative challenges for the IRS. Many of today's partnership transactions involving exempt organizations, for example, raise multi-functional tax issues such as whether the entity is properly classified as a partnership for federal tax purposes, whether the recently enacted section 168(j) tax-exempt entity rules come into play, and whether the exempt organization's participation in the transaction furthers private as opposed to public purposes. From an administrative perspective, these issues are considered by three separate functions in the IRS. A recent survey of ruling requests submitted to the exempt organizations function in the IRS reflected that there were, in at least a few instances, multi-functional tax consequences that needed to be considered.

The IRS must also be prepared to respond from a compliance perspective. Examining agents must be able to identify and resolve multi-functional tax aspects of sophisticated transactions. Similarly, the Service must be prepared to revise the information reporting system to gather data needed to analyze current exempt organization activities. The extent of charities involvement in partnership transactions and the reason for such involvement, for example, cannot be garnered from the current information returns. It is not known whether charities are using privately syndicated partnerships as vehicles to accomplish exempt purposes, as vehicles to invest in as limited partners, or as vehicles to generate extra capital by entering into transactions that permit the transfer of tax benefits from an exempt entity to a taxable entity.

Perhaps the critical threshold issue in looking at the changing character of exempt organizations is to determine just how commercial these

organizations have become. Later this year it is anticipated that the House Ways and Means Subcommittees on Oversight will hold hearings on the unrelated business income tax rules and consider, in part, the issue of unfair competition by exempt organizations. It is also expected that the House Ways and Means Subcommittee on Select Revenue Measures will hold hearings to study the treatment of pass-through entities established or facilitated under the Internal Revenue Code. It is anticipated that the hearings will focus, in part, on the participation of exempt organizations in partnership transactions.

Having reviewed some of the factors that have led exempt organizations to participate in partnership and joint venture transactions with non-exempt entities, I would like to spend the remainder of my time discussing the tax consequences of a charity's participation as a general partner in a limited partnership venture. As your outlines indicates, this was the subject of an article that I wrote in the December 23, 1985 issue of *Tax Notes*.

Many charities that have been unable to raise sufficient capital to pursue their exempt purposes have turned to limited partnerships as appropriate vehicles to obtain funding. One of the most common financing techniques involves a charity's participation in limited partnership ventures either as the sole general partner or as one of several general partners. The limited investment partnership is often seen by the charitable organization as the ideal vehicle for the pooling of funds because it attracts investors by offering a return on investment capital, limited risk, and substantial tax benefits. This financing technique has been scrutinized to determine if the charity's partnership obligations conflict with its obligations under section 501(c)(3). Under the principles of partnership law, the general partner or partners manage and assume the overall risk of the venture. General partners also have a statutorily defined obligation towards a limited partner who takes no part in running the business, and whose risk in turn is generally limited to the extent of the capital contribution. In this context the charity, as a general partner, is subject to fiduciary principles that it exercise prudent business judgment and use its best efforts to further the interest of the partnership. Under the principles of federal tax law, however, the charity is also subject to section 501(c)(3) which requires that it be organized and operated exclusively for public, charitable purposes, and not for the private benefit of profit-motivated limited partners. Thus, a charity can be faced with a conflict between its fiduciary duties and meeting its obligations under the Internal Revenue Code.

The use of a limited partnership arrangement for the purpose of procuring private venture capital to further an exempt purpose was initially considered over a decade ago with respect to the construction, ownership, and operation of low-income housing. Commercial financing was not fea-

sible because potential lenders for these projects generally required substantial equity contributions, and because rents paid by low-income tenants seldom covered market rate financing. In this situation many charities looked to profit-motivated developers and private investors for capital.

In General Counsel Memorandum 36293, the Office of Chief Counsel addressed this issue with respect to an individual case in which an organization provided such housing on a nondiscriminatory basis in a predominately white suburb of a large metropolitan area. The GCM concurred in the issuance of an adverse private letter ruling holding that the organization failed to demonstrate that its activities served a recognized charitable purpose. It was determined that the project was not relieving the poor or the distressed in that too small a percentage of the housing project units were rented to low-income persons. In addition, the GCM advised that the organization's role as a sole general partner in the limited partnership venture made the organization a direct participant in an arrangement for sharing the net profits of an income-producing venture with private individuals or institutions of a non-charitable nature. This was seen as "legally incompatible" with the statutory requirement that section 501(c)(3) organizations be operated exclusively for public, charitable purposes.

The use of a limited partnership to raise private venture capital to finance an exempt activity received judicial consideration in 1978 and 1979. At that time, three section 501(c)(3) organizations sought a declaratory judgment as to their exempt status after receiving adverse rulings from the IRS. The first two cases were *Change All Souls Housing Corp. v. United States*[1] and *Strawbridge Square, Inc. v. United States*. Both were filed in the Claims Court in 1979, and the government conceded during litigation that both entities were exempt organizations. The cases are mentioned because they involve organizations formed to provide low-to-moderate income housing, and are similar to the organization discussed in GCM 36293.

Both *All Souls* and *Strawbridge* were nonprofit organizations formed and controlled by a section 501(c)(3) parent to foster the development of low-to-moderate income housing. Both accomplished their purpose by acting as general, non-managing partners in a limited partnership, and receiving a small percentage of the partnership profits in return. *All Souls* was required to monitor management policies and make recommendations to the managing partners in an effort to promote the exempt purposes for which it was organized. *Strawbridge's* responsibilities included monitoring, assisting, and coordinating with the managing partner, with

[1] 671 F.2d 463 (Ct. Cl. 1982).

the objective of promoting its exempt purposes. In retrospect, it appears that the partnership agreements of both organizations were structured to further the organizations' exempt purposes and to avoid a conflict of interest. These fact patterns can be contrasted with GCM 36293 where the organization seeking exempt status was the managing general partner solely responsible for the general management and supervision of the housing project. In this capacity, without further limitation in the partnership agreement, the organization's fiduciary obligation of furthering the private financial interests of the limited partners necessarily created a conflict of interest that was incompatible with the statutory requirement that it operate exclusively for its charitable purpose.

The third case to receive judicial attention concerning the issue of charities as partners was *Plumstead Theatre Society, Inc. v. Commissioner.*[2] Plumstead was a nonprofit corporation formed to promote and foster the performing arts. It co-produced a play with the Kennedy Center entitled "First Monday in October," in which Plumstead and the Kennedy Center were each to provide one-half of the capitalization required for the production, and to share equally in any profits or losses from the play. Prior to the premiere of the play, Plumstead encountered difficulties in raising its share of the capitalization costs. To meet its obligations under the agreement, Plumstead sold a portion of its rights in "First Monday" to outside investors through a limited partnership. Plumstead was the general partner and two individuals and a proprietary corporation were the limited partners under the partnership agreement. The limited partners were required to contribute $100,000. In return, they were collectively to receive a 63.5 percent share in any profits or losses resulting from the play. Plumstead eventually closed "First Monday" at a loss. An adverse ruling was issued to Plumstead on the basis that it had a substantial commercial purpose and that, in light of the partnership arrangement, it was operated for the benefit of private rather than public interests.[3]

The adverse ruling was litigated in a declaratory judgment proceeding in the United States Tax Court. A significant portion of the Tax Court opinion pertained to the court's view that Plumstead was not operating in furtherance of a substantial non-exempt, commercial purpose.[4] Indeed, only one paragraph of the opinion dealt with the limited partnership issue. The Tax Court found the partnership agreement by its terms afforded adequate protection to Plumstead. The court noted that the limited partners had no control over the way Plumstead operated or managed its affairs, that the partnership agreement resulted from an "arms-

[2] 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

[3] *Id.* at 1327-28.

[4] *Id.* at 1331.

length transaction" in which the investors paid a "reasonable price" for their interest, and that the arrangement was unobjectionable because it was limited to one play produced by Plumstead.[5]

On appeal to the Ninth Circuit, the government focused upon the argument that Plumstead was operated for the benefit of private limited partners. The government argued that production of "First Monday" was Plumstead's overriding activity with nearly two-thirds of any profit from the venture going to private investors. Indeed, under applicable state law, Plumstead was obligated to conduct the partnership to maximize their profits. Equally important was the fact that the partnership agreement required that Plumstead exercise fiduciary responsibility as general partner to employ partnership assets for the "exclusive benefit" of the partnership. The partnership agreement was not structured to preclude a conflict between Plumstead's fiduciary obligations and its exempt purposes.

The Ninth Circuit's opinion is a disappointment to those who hoped for judicial clarification of the issue of an exempt organization's participation in a limited partnership venture. Although the issue was placed in a clear focus for the appellate forum, the court, in a one page opinion, merely found the Tax Court's findings not clearly erroneous. The court referred to the one paragraph of the Tax Court opinion, and in a similar one paragraph analysis, affirmed the conclusion that Plumstead was operated exclusively for charitable purposes.[6]

An exempt organization's role as a general partner in a limited partnership received further consideration subsequent to the *Plumstead* litigation in GCM 39005. That GCM considered an exempt organization that was one of four general partners in a limited partnership formed to construct, own, and operate a federally-financed apartment project for low-income, handicapped, and elderly persons. The GCM enunciated a two-part test that in essence evolved from the earlier legal opinions:

> An exempt organization's participation in a partnership arrangement as a general partner should not per se result in denial of section 501(c)(3) status. The partnership arrangement, however, should be closely scrutinized to assure that the statutorily-imposed obligations on the general partner do not conflict with the organization's ability to pursue its charitable goals. Thus, in all partnership cases, initial focus should be on whether the organization is serving a charitable purpose. Once charitability has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners.

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[5] *Id.* at 1333-34.

[6] Plumstead Theatre Soc'y, Inc. v. Commissioner, 675 F.2d 244 (9th Cir. 1982).

My final analysis in the *Tax Notes* article is that there is a tension between partnership law and charity law. A review of the existing legal opinions suggest that it is not the legal form of the partnership that is the controlling issue, but rather the substance of the rights, duties, and liabilities negotiated by the parties that will determine whether a partnership arrangement permits the exempt organization to operate exclusively in furtherance of its exempt purposes, or to operate for the benefit of limited partners. Accordingly, any partnership agreement must be carefully structured and evaluated. The question of whether a limited partnership agreement jeopardizes the exempt status of a general partner is one that can only be determined on the facts and circumstances of each case.

In Bruce Hopkin's response to my article, it is clear that there are some differences of opinion, but it is also clear that there are some common grounds. Bruce says that while he does not like the IRS test, it is not to say that the federal tax law ought not to impose some boundaries on when a charitable organization can participate as a general partner in a partnership. Another commentator, the lawyer who successfully litigated the *Plumstead Theater* case, Mr. William Lehrfeld, recently stated in an article in the *Institute On Federal Taxation* that the investment partnership does face examination when the private partners take more advantage from that status within the partnership than the advantage gained by the exempt organization.[7]

Finally, I'd like to express my reservations and perhaps concerns that the issues that were pertinent in many of the earlier cases involving charities as general partners may not be relevant to the sophisticated, financial transactions of today. One recent case of particular concern is a Tax Court case entitled *Smith v. Commissioner*. It should be emphasized that while Georgetown University was a party to the transaction in question, Georgetown University itself was not a party to the case. The facts essentially involve Georgetown's purchase of Alban Towers apartment building to house students. The operation of that building ran up heavy losses to the extent of $250,000 in 1974 and $435,000 in 1975. Fearing that these losses would deter endowments, it arranged to sell the mortgaged building to a limited partnership including the University Vice President for Financial Affairs and Treasurer, and the Treasurer of the Alumni Association for, in effect, $300,000 and a $2.8 million note. Georgetown kept a twenty percent interest as a general partner; it ran the dorm and subsidized losses with loans. It received no interest on the note for the loans, but treated unpaid interest as its capital contributions.

Georgetown did not transfer title of the property to the partnership.

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[7] Lehrfeld, *Dealing With Investors and Other Methods of Generating Income: Tax Aspects of Revenue Producing Activities*, 42 INST. ON FED. TAX'N § 26.02[2], at 26-15 (1984).

However, it made all operating decisions, paid all bills, and entered into and enforced all leases in its own name. On paper, it converted its operating losses into investments, and for all outlays, the sixteen limited partners deducted eighty percent of the losses. The IRS challenged the personal deductions claimed by the limited partners. The Service position was upheld when the Tax Court found the partnership was a sham. The court stated that there were no valid business purposes of the joint venture; that the partnership did not transfer equity with the benefits and burdens of ownership to the limited partners; and that the limited partners were not the owners of Alban Towers.

The Alban Towers transaction took place ten years ago. Clearly the exempt organizations issues were not considered. It is likely in today's environment, the issue of the status of the exempt organization in such a transaction would be analyzed.

Perhaps the *Smith* case is an early confirmation of the types of sophisticated, complex transactions that exempt organizations are involved in. This is an area of increasing concern, and there is great interest in trying to determine just what type of transactions exempt organizations are entering into today. I think it is fair to say we do not have the data that will satisfy our curiosity. In any event, this is one of the most topical issues in the exempt organizations community, and I am sure that it will receive increasing attention in the days and years ahead.